Bond Case Briefs

Municipal Finance Law Since 1971

Inflation Isn't All Bad for Tobacco Bonds Battered by Selloff.

- **Illinois settlement, inflation boost payouts to $7.3 billion**
- **About $90 billion muni bonds are backed by settlement payments**

There's a little bit of good news for tobacco municipal-bond investors who have been battered by the market sell-off. The inflation that fueled the rout to begin with is, in a fortunate twist, boosting the revenue backing their holdings.

Payments to U.S. states this year under a 1998 national settlement with major tobacco companies rose by 10%, despite a decline in cigarette sales, according to figures disclosed late last month by the National Association of Attorneys General. That's in part because under the settlement, the companies have to increase their annual payments to adjust for inflation.

Tobacco companies led by Altria Group Inc. paid 46 states and territories about $7.3 billion, the highest since 2013, the data show. Along with a one-time windfall from a legal settlement, the 7% inflation adjustment helped offset a 6.1% cigarette sales decline.

"Inflation this year was helpful for tobacco bonds from a payment stance," said Sarah Gehring, a municipal credit analyst at UBS AG.

That said, it hasn't helped returns. Junk and non-rated tobacco bonds have lost about 16.3% so far this year, the worst sector among high-yield municipal debt, according to Bloomberg indexes. High-yield muni funds, suffering from a flood of investor redemptions, typically sell tobacco bonds first because they are among the most liquid high-yield muni securities. By contrast, investment grade tobacco bonds have lost 8.9% this year, about the same as the overall market.

Investors have pulled about $8.2 billion from high-yield muni funds this year amid a broad bond-market selloff and are on pace to break the record set in 2013, according to Refinitiv Lipper US Fund Flows data.

"A lot of the movement we see in tobacco is really technically driven," said Dan Barton, head of municipal research at Insight Investment Management.

Tobacco bonds are the worst-performing sector within high-yield munis

Illinois Settlement

State and local governments settled with cigarette makers to compensate taxpayers for decades of public health costs associated with smoking. Some governments have sold bonds, borrowing against the payments they expect to receive over years from this settlement. Payments on about $90 billion tobacco bonds outstanding, by par value, are based on cigarette shipment volumes, according to data compiled by Bloomberg.

To be sure, most of the payment increase to states this year came from an extra $546 million Illinois received to settle a dispute over money withheld by tobacco manufacturers. Excluding Illinois' windfall, payments rose 2% on average because of the inflation adjustment, according to UBS.

The tobacco settlement agreement requires manufacturers to boost their annual payments at least 3% — or more if inflation is higher. Inflation rose 7% in the 12-months ended December 2021 and has since increased to 8.5%.

After rising in 2020, the first year of the pandemic, tobacco sales fell in 2021 as federal pandemic stimulus payments wound down, said Gehring.

And those declines continue. Altria estimated that domestic cigarette industry shipment volume decreased 6.3% in the first quarter of 2022.

Smoking Habits

A combination of higher gas prices, consumer-goods inflation and the recent conclusion of Covid-19 relief programs is likely weighing heavily on smoking habits, according to Bloomberg Intelligence analyst Kenneth Shea.

Last week, the Biden administration disclosed details on a proposed ban on menthol cigarettes, which make up around 30% of U.S. cigarette sales, according to Barclays Plc.

Tobacco bonds issued in the last few years are structured to withstand significant smoking declines. Illinois bonds issued in 2017 and rated A by S&P Global Ratings Inc, were structured to withstand annual tobacco shipment declines of about 18% without defaulting.

However, junk and non-rated tobacco bonds — which have a higher ratio of outstanding debt to annual payments from the companies and long maturities — are vulnerable to lower smoking rates and more sensitive to regulatory changes. Earlier vintages of the bonds assumed smaller annual consumption declines, of 3% to 4%, and carry greater risk.

In addition to its annual payment of about $260 million, Illinois received an extra payment to resolve a long-running dispute with tobacco companies over allegations the state wasn’t enforcing a statute aimed at protecting them from losing market share to firms that didn’t sign onto the 1998 agreement.

Since the national settlement imposed significant costs to the tobacco companies that participated, states adopted laws assessing similar costs on cigarette makers that didn’t participate to level the playing field. Disputes arose in Illinois and other states over the enforcement of the statues and as a result tobacco companies withheld payments.

In 2013 and 2021, arbitration panels found that Illinois had upheld its obligation. The settlement resolves the companies’ dispute with Illinois until 2028.

Although the additional payment is positive for Illinois tobacco bond holders, prices on the $670 million securities are little changed as the muni market contends with near-record outflows.

Bloomberg Markets

By Martin Z Braun

May 4, 2022